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SUBJECT: EU PROPOSES TO REGULATE CREDIT RATING AGENCIES

**¶1.** (SBU) SUMMARY. On November 12, 2008, the European Commission published its proposal to regulate Credit Rating Agencies (CRAs). The proposed Regulation seeks to introduce a new mandatory registration and surveillance regime, and to harmonize rules on CRAs throughout the EU, ensuring that ratings are not affected by conflicts of interest, that CRAs pay special attention to the quality of their ratings and rating methodology, and that they act in a transparent manner.

MANDATORY REGISTRATION, IMPROVED CORPORATE GOVERNANCE AND ENHANCED TRANSPARENCY

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**¶2.** (SBU) The proposed Regulation Q which, unlike a Directive, is applicable directly in its entirety to all Member States contains the following key provisions:

MANDATORY REGISTRATION AND SURVEILLANCE - Credit rating agencies will be required to register in a central European database, established by the Committee of European Securities Regulators (CESR). The database will gather historical rating information, allowing users to compare rating performance. CESR will serve as facilitator, but the responsibility for registration and surveillance of the credit rating agency will remain with the competent authority of the home Member State. Supervisors will not approve ratings; only ensure compliance with the rules.

AVOIDANCE OF CONFLICT OF INTEREST - CRAs will be required to disclose the names of rated companies that contribute more than 5% of their revenue. They will also be forbidden to rate companies in which their analysts own shares or financial products. CRAs will be required to limit their activity to credit rating and related operations, excluding consultancy or advisory services.

INDEPENDENT CORPORATE GOVERNANCE - Each agency will be required to have on its board at least three independent directors, at least one of them an expert in securitization and structured finance. Their remuneration will be based on a fixed fee and their five year term is non-renewable. Analysts will have a four year rotation requirement, and their compensation must not be contingent on revenue from issuer. They will not participate in fee negotiations and will not hold financial interests in the rated entities.

ENHANCED TRANSPARENCY - CRAs will be required to regularly disclose their methodologies, models and rating assumptions, and the general nature of their compensation policy.

TRADITIONAL VERSUS STRUCTURED PRODUCTS - The proposal seeks to enable investors to distinguish between ratings for structured products and for traditional products. CRAs will have the option of either using a different rating scale for structured products, or to provide detailed information on the different risk categories.

ALL CRAS WILL NEED TO REGISTER

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13. (SBU) No financial institutions in Europe will be allowed to trade rated instruments without that instrument carrying a rating from an-EU registered CRA. This will essentially require all CRAs (the majority of which are from the U.S.) to register in the EU and fulfill the criteria above.

COMMISSION PROPOSAL GOES BEYOND IOSCO

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14. (SBU) The European Commission believes that the self-regulation regime currently applicable to Credit Rating Agencies Qbroadly failedQ. Commissioner McCreevy noted to the press that the proposed regulation will help CRAs regain the market confidence they lost because of their role in the financial crisis. The Commission acknowledges that the reference point for its proposal is the QIOSCO Code of Conduct Fundamentals for Credit Rating AgenciesQ, but it

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points out that it has "gone beyond these standards in those areas where we felt that more exacting measures would be appropriate". Commissioner McCreevy stated at a press conference that the Financial Markets Regulatory Dialogue is the vehicle for discussing such regulatory matters with U.S. counterparts, but that the proposed regulation is not conditional on U.S. approval.

OUTLOOK

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15. (SBU) The Economic and Monetary affairs Committee of the European Parliament will begin its examination of the Regulation proposal on December 1, under the leadership of Austrian Christian Democrat Ottmar Karas, rapporteur. The Commission aims for adoption before the summer of 2009. However Commission officials admit privately that that may be difficult to achieve.

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